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Enclosed are:

1) Brief of Al Sterman for the Arizona Consumers Council

2) Summary of Al Sterman Testimony

3) Summary of Dr. Mark Cooper Testimony

for Docket: RE-0000C-94-0165

Barbara Sherman

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
COMMISSIONER-CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF THE COMPETITION IN) THE PROVISION OF ELECTRIC SERVICES) THROUGHOUT THE STATE OF ARIZONA)	DOCKET NO.RE-0000C-94-0165 FORMERLY U-0000-94-165

BRIEF OF ALBERT STERMAN
ON BEHALF OF THE
ARIZONA CONSUMERS COUNCIL

BRIEF (March 16, 1998)

First, we wish to thank Hearing Officer Rudibaugh, his staff, Deborah Scott and the staff of RUCU, as well as the many others who extended courtesies to us during the evidentiary hearings on stranded costs. Restructuring generation particularly and the onset of retail competition in the electric utility industry will bring great changes to providers, marketers, and consumers of electricity. The unknowns are almost too numerous to mention. Each question and/or answer leads to more questions. The hearings, while very informative, also brought out many questions.

It is becoming increasing clear that small consumers may be at risk of higher prices, diminished service, less reliability, and may be victims of fraud by unscrupulous sellers resulting from deregulation. **The guiding factor in this restructuring for the Arizona Corporation Commission should be to protect the small consumers.** The Arizona Consumers Council suggests that the Commission constantly remember their need to do no harm--especially to the most vulnerable and unsophisticated consumers. A secondary guiding factor must be that **all must share in the savings and the costs**. The Arizona Consumers Council opposes the subtle--and not so subtle--attempts to shift costs onto small consumers. For example, Dr. Rose's comments that existing contracts would not be redone to include charges. (See transcript, page 3120.) All efforts such as this simply shift costs to small consumers. Since the charge framework is new, there seems no reason that it not be incorporated into contracts. It will be incorporated into the rate base of all non-contractual customers.

If there are no savings from competition in generation, the Commission should **revisit its rules** to prevent adverse impacts on the small consumers. It is generally understood that large users will fair well under deregulation.

The Arizona Consumer Council re-affirms its position that the Commission should reject **the utilities' proposal to recover 100% of unmitigated, "prudent", stranded costs.** The utilities must not be permitted to recover more than would be recoverable by an efficient utility in the private sector. (See Mark Cooper, Testimony, p. 1). Utilities should be given the opportunity to recover non-discretionary costs due to regulation, and costs which would, if not recovered, put the utility at financial risk.

There must be a sharing of these uneconomic costs between stockholders and consumers. Dr. Cooper concurred with Dr. Rosen that **50-50 is a reasonable starting point.** Although, at present, we have no real knowledge of the magnitude of strandable (stranded) costs, it may be large enough to have serious consequences to residential consumers. The numbers must be quantified and the impacts known before policy decisions are made. Prior to the calculation and allocation of stranded costs, utilities must be given incentives to make every reasonable effort to mitigate.

In calculating stranded costs there must be a "netting" of above and below market assets. Additionally the Commission must take into account any asset which would, if kept and used in the competitive market, become a revenue stream. There should at least be a sharing of these assets with consumers.

An important protection for those on standard offer should be a cap and a reduction in price, compared to present rates. If and when the Commission analyzes rates and finds that there has been a reduction in the price of generation, consumers on standard offer should receive the benefits of such reductions.

The Arizona Consumers Council opposes a rate freeze because it could allow utilities and producers of generation to benefit from lower prices with no corresponding benefit to consumers.

The Systems Benefit Charge should include funds for universal service, for low income, rural and other high cost consumers. System benefits or social costs need to be recovered from all customers, not just residential and small business consumers who generally use a low amount of electricity, usually at peak hours. **The Arizona Consumers Council supports full funding of the Systems Benefit Charge and provisions for solar energy.**

No exemptions from stranded costs should be allowed. Utilities over the years have been rewarded risk premiums and implicit guarantees against bankruptcy, which we are still proposing. The Commission must not now shift the burden of stranded costs to ratepayers. **The wires charge (CTC) captures most consumers. Any collection of stranded costs or system benefits should be collected in this method from all consumers.** Bypass by new self-generators, new producers and those on standby who are in far better economic conditions than residential, small business and vulnerable consumers should not be permitted to forgo their fair share of these costs. A way must be found to insure that all parties pay for these costs. Exit fees should not be permitted unless we know the magnitude of stranded costs and a method formulated which will insure those exiting the system pay their true share.

The Arizona Consumers Council has recommended a bottoms up approach to calculation of stranded costs, forcing the utilities to justify the costs they believe to be stranded. While we do not oppose divestiture, it does not absolve the utilities or the Commission from determining true book value. We support a wires charge paid by all to cover stranded costs.

The Commission must reject securitization as a means of paying any stranded costs. **We must not go for a financial gimmick that uses the power of the State of Arizona to tax a specific class of customer--electric ratepayers --to lower the cost of capital.**

We must create mechanisms for funding the provider of last resort obligation now born by utilities. We must insure affordable electricity for low income and all consumers. We need to promote conservation and environmental protections. A major concern of the Arizona Consumers Council is how residential, small business, low income and other vulnerable consumers will fare. Aggregation as a boon to small consumers is important. How and who will aggregate? Will there be protections for the public? Is aggregation a reasonable option? These are fundamentally different from but also related to stranded costs.

Returning to stranded costs, as we noted above, there are more questions than answers. The role of the Arizona Corporation Commission is very important in the determination of answers to our questions. Some of the questions that must be resolved to benefit small consumers are:

How much stranded costs, uneconomic costs, are there?
What positive and negative factors will be used to determine these costs?
Who will pay for stranded costs?
Will these uneconomic costs be apportioned between ratepayers and stockholders?

As Dr. Mark Cooper testified, it is absolutely critical that sharing take place. He suggested a 50-50 starting point. Because this sharing is so critical, this point is where we end our testimony brief.

SUMMARY

DIRECT TESTIMONY OF ALBERT STERMAN

STRANDED COST DOCKET NO. U-000-94-165

My direct testimony is the Arizona Consumers Council's and my own perspective on the issue of stranded costs in the above docket. It also attempts to answer the nine issues cited by staff in their in the Arizona Corporation Commission's Procedural Orders dated December 1 and 11, 1997. The issues are prioritized in the summary.

The most important issues facing the Commission as we move into this new competitive arena is how we protect residential, small business and low income consumers from the downside of competition. Large users of energy (i.e. mines, large industrial and commercial businesses, and government entities will have little trouble cutting deals with the utilities and new market entrants for the lowest possible prices. For these customers a relatively small reduction in generation costs could mean Hugh savings. But, small consumers because they are dispersed and consume relatively small amounts of electricity may, in fact be at the mercy of utilities and new market generators. Small consumers may be forced to pay above market prices.

Stranded Costs must be collected from those who participate in the competitive market. Consumer who will be on Standard Offer or do not or cannot participate are now, and will continue to pay for stranded costs in their Commission approved rates. The calculation must include the netting of negative and positive stranded costs. Additionally, the Commission should review any new revenue opportunities that will be made available to present assets, previously compensated risk, imprudent investment as well as prudent unmitigated investments.

The calculation methodology should be Replacement Cost Valuation. This method has the support of almost all of the Consumer groups present at the working groups sessions. It is the only way that the Commission can

BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE COMPETITION IN	)	
IN THE PROVISION OF ELECTRIC SERVICES	)	DOCKET NO. U-0000-84-165
THROUGHOUT THE STATE OF ARIZONA	)	

TESTIMONY OF

DR. MARK N. COOPER

ON BEHALF OF

THE ARIZONA CONSUMERS COUNCIL

JANUARY 21, 1998

SUMMARY

1. SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING STRANDED COSTS, IF SO, HOW?

A. The rules should be clarified to allow the utility recovery of costs that only an efficient utility would have incurred. They should not allow the full recovery of above market costs as proposed by the companies. In my testimony I show that the company's proposal rely on an assumed relationship between ratepayers and utilities that never existed. This relationship has been fabricated by the utilities to protect them from the impact of competition. This fictitious relationship has the effect of denying consumers the benefit of efficient prices in the marketplace. It has no legal, regulatory, or economic basis.

There is a relationship between ratepayers and utilities in which the company is required to deliver service in an economic fashion. Uneconomic costs are not recoverable from ratepayers. The company has no claim to the costs that it wants to have guaranteed. If the Commission decides to rely more on competition to accomplish the regulatory goals and obligations which have always applied to the electric utility industry, it cannot and should not allow the recovery of stranded costs calculated as proposed by the Company.

3. WHAT COSTS SHOULD BE INCLUDED AS PART OF "STRANDED COSTS" AND HOW SHOULD THOSE COSTS BE CALCULATED.

There are two circumstances in which costs may become stranded and recoverable from ratepayers.

First, management must have exercised no discretion whatsoever over costs, i.e. costs may have been incurred directly and entirely by legislative or regulatory edict. Such costs must also be unrecoverable. Management must also not have been previously compensated for the risk of stranding. The question is an empirical one -- who made the decisions, under what conditions and subject to what risks and rewards.

Second, even where management is responsible and should not normally be compensated for costs going forward, but the result would be severe financial distress, ratepayers may have to allow recovery of costs that they should not otherwise bear for a transition period. If the analysis reveals uneconomic costs for which management is responsible but the utility would not survive financially, if it bore the burden of the costs, ratepayers may allow recovery of costs while the utility's economic house is put in order.

Having established the fact that a utility only has a claim to recover the efficient costs of production and that the Commission has never been required to allow the recovery of uneconomic costs, we turn to the question of how to measure the economic costs of production. There are two relevant standards that should be considered.

One standard is the most efficient producer standard. Under routine assumptions about competitive market behavior, this would be the market clearing price. In essence, we ask at what price would competitive supply clear the market. This is a relevant consideration because competition would force producers to continuously evaluate and choose the most efficient technology. In a competitive market, if you get stuck with an inefficient technology, you suffer inadequate returns or losses until you lower your costs.

A second standard is the most efficient utility standard. This standard recognizes that certain obligations were placed on utilities. While they might have been able to choose the most efficient plant for any specific decision about a specific increment of supply, they may also have been required to make decisions that were not strictly least costs in the aggregate for policy reasons. For example, they might be required do things a competitive profit maximizer might not do, such as to have a larger reserve margin, a different resource mix, or a higher level of reliability. However, it is crucial not to confuse the fact that a utility was required to have more capacity with the fact that it paid too much for that capacity. The former is a policy obligation, the latter is a management mistake.

Based on my analysis of other utilities with large stranded costs, it is interesting to analyze the sources of these uneconomic costs. As in other cases, the market value that the Arizona utilities anticipate equals roughly the operating costs of those facilities. The utilities, operating costs are actually close to the operating costs of other utilities. Its capital charges are much higher. Return of and on capital contribute about equally to its uneconomic costs.

Given the financial constraints, in these cases I have argued that ratepayers should be held responsible for, at most, 50 percent of stranded costs. As discussed throughout my testimony, management must be responsible for their share of stranded costs where management discretion was exercised. This frequently works out to a return of, but not on capital.

6. HOW AND WHO SHOULD PAY FOR "STRANDED COSTS" AND WHO IF ANYONE SHOULD BE EXCLUDED FROM PAYING FOR STRANDED COSTS?

I recommend the following approach to the calculation and allocation of stranded costs. The purpose is to allocate responsibility between ratepayers and stockholders (50/50 in the example) and then between customer classes to ensure the affordability of service.

1. Calculate Economic Costs of Production
2. Estimate Stranded Costs
3. Decide on Recoverability of Stranded Cost
4. Apportionment Between Stockholders and Ratepayers
   --> 50 % to Stockholders
   --> 50 % to Ratepayers
5. Allocate Stranded Costs to Non-residential
   --> (Baseload Kwh + ?)/Baseload Kwh to Non-residential
6. Allocate Residual to Residential
   --> (Baseload Kwh - ?)/Baseload Kwh to Residential
7. Minimize Impact on Basic Service to Assure Affordability
   --> Inverted Charges
8. Promote Universal Service for Targeted Groups
   --> Exempt Low Income from Stranded Cost Recovery

9. WHAT FACTORS SHOULD BE CONSIDERED FOR THE "MITIGATION" OF STRANDED COSTS?

I would reverse the direction of the incentive with respect to mitigation. I prefer to have utilities write down their plant first and place stockholders at risk for the write-down. To the extent that management can mitigate stranded costs, stockholders would enjoy the benefits. This is exactly the way it would work in the marketplace. Thus, after stranded costs are reasonably estimated and responsibility ascertained, utilities can be the beneficiaries of opportunities to mitigate stranded costs or incentives to improve operating efficiencies. It this approach is taken, the Commission does not have to concern itself with policing mitigation.